Marquette Law Review

Volume 52
Issue 1 *Summer 1968*

Article 8

Accountants' Liability to Third Parties for an Audit

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NOTES

Accountants' Liability to Third Parties For An Audit: In ascertaining the current financial status of a corporation the primary source of reliable information is the independent audit. The audit is prepared by a certified public accountant who is hired by a corporation for the sole purpose of conducting the audit. This gives a potential investor an objective view, one which is not tainted by corporate self-interest. This is the reason that an investor looks first (and often last) to the independent audit. However, the reliance which an investor places in the work of the independent accountant is not fully recognized by the courts. For example, if an accountant is negligent in the preparation of an audit and an investor is damaged by his investment in the corporation in reliance upon the audit, the investor has no cause of action against the accountant for his negligence. The corporation hired the accountant, not the investor. Thus, there is no consensual relationship between the investor and the accountant, and no basis for liability except fraud.

Background Cases and Recent Developments

The rule that an accountant is not liable to investors in the absence of fraud or privity, has protected accountants since they became recognized as a "skilled professional class" in 1905.[1] The case of *Ultramares Corporation v. Touche*[2] firmly established the rule that an accounting firm would not be held liable to third party investors for negligence. Justice Cardozo stated that an investor, not in privity, could recover only if the accountant's negligence was so gross as to "sustain an inference of fraud."[3] In subsequent cases this basic test was held to extend liability only if the accountant made a "reckless misstatement" or had "no genuine belief" in the facts in an audit.[4] In *Duro Sportswear v. Cogen*,[5] the *Ultramares* standard was rigidly adhered to. In *Cogen* the plaintiff was one of two shareholders in a corporation, and the audit set the price of stock for a sale to the other shareholder. The purpose and the parties were known to the auditor. The court held that the auditor had no duty to exercise reasonable care and in the absence of privity between the shareholder and the auditor the shareholder would have to prove fraudulent conduct. Thus, the third party investor had to convince the jury that the accountant was a "cheat" and not a mere "blunderer," and that the accountant actually knew the audit was in error when he submitted it.[6]

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[1] Smith v. London Assurance Corp., 109 App. Div. 882, 96 N.Y.S. 820 (1905).
[2] 255 N.Y. 170, 174 N.E. 441 (1931).
[3] *Id.* at 191, 174 N.E. at 449.
[4] State Street Trust Co. v. Ernest, 278 N.Y. 104, 15 N.E.2d 416 (1938). *See* Annot., 54 A.L.R. 2d 345 (1957).
[5] 131 N.Y.S.2d 20 (Sup. Ct. 1954).
[6] Note, *The Judicial Process—Ultramares Corp. v. Touche*, 26 ILL. L. REV. 49 (1931).

Recently, the limited liability of accountants to investors has come under increasing fire and the *Ultramares* decision is being questioned.[7] This is illustrated by the recent case of *Rusch Factors, Inc. v. Levin*[8] where the defendant-accountant knew the plaintiff was the sole creditor and that he would be relying upon the audit. The Federal District Court found the accountant liable even though there was an absence of fraud and a lack of privity with the plaintiff. This decision is contrary to the holding of the New York Court in *Duro Sportswear v. Cogen.*[9] However, *Rusch Factors, Inc. v. Levin*[10] did *not* hold that an accountant may be sued by *any* investor for negligence. Rather, the rule of *Ultramares Corporation v. Touche*[11] was distinguished and the court applied the rule of *Glanzer v. Shephard.*[12]

> . . . the case at bar is qualitatively distinguishable from *Ultramares.* There, the plaintiff was a member of an undefined, unlimited class of remote lenders and potential equity holders not actually foreseen but only foreseeable. Here the plaintiff is a single party whose reliance was actually foreseen by the defendant. The case at bar is, in fact, far more akin to the case of *Glanzer v. Shephard.* . . . The Court does not rule upon, but leaves open for reconsideration in the light of trial development, the question of whether an accountant's liability for negligent misrepresentation ought to extend to the full limits of foreseeability.[13]

Thus, *Rusch Factors Inc. v. Levin* stopped short of holding accountants liable to all reasonable foreseeable third party investors on the basis of negligence. However, unlike *Ultramares* which based liability on a consensual relationship, *Rusch Factors Inc. v. Levin* revitalized the "end andaim" concept of *Glanzer v. Shephard* and applied it to accountants. The accountant's liability was based on the *contemplated use* of the audit of which the accountant was aware when he prepared the audit. This concept could be easily expanded so that accountant's liability to third parties can be based on the contemplated use of the audit. For example, if an accountant negligently prepared an independent audit and knew it was to be distributed to the general public for the sale of stock, the

[7] Investor confidence, economic growth and stability are probably the basic causes of the increase in suits by investors. Some specific reasons are given by Alfred F. Yaude in *The Impact of Changing Economic Philosophies on the Public Accountant,* 1966 THE NATIONAL PUBLIC ACCOUNTANT 4 (Dec.).

[8] 284 F. Supp. 85 (D. R.I. 1968). Another example is the recent case of Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967), which held that an accountant has a duty to disclose to the investor known material errors discovered after an audit has been released to the public.

[9] 131 N.Y.S.2d 20 (Sup. Ct. 1954).

[10] 284 F. Supp. 85 (D. R.I. 1968).

[11] 255 N.Y. 170, 174 N.E. 441 (1931).

[12] 233 N.Y. 236, 135 N.E. 275 (1922). The defendant was a bean weigher who contracted with a bean seller to weight a shipment of beans and certify the weight to the plaintiff-bean buyer. The plaintiff (buyer) was able to recover from the defendant (weigher) even though there was no privity, since the "end and aim" of the transaction was known to the defendant.

accountant could be held liable to any stock purchaser relying upon the audit. On the other hand, an accountant called in to conduct an audit with the understanding that it was to be used to obtain financial backing from a bank would not be liable to purchasers of stock relying upon the same audit reprinted in a prospectus. This is essentially the position taken by the Restatement of Torts § 552, Tentative Draft No. 12: "It is sufficient, in other words, that the maker knows that the information is intended for repetition to a certain group or class of persons, and that the plaintiff proves to be one of them, even though the maker never had heard of him when the information was given."[14] Tentative Draft No. 12 makes it clear that the liability of an accountant is limited to the particular transactions which he intends, or knows the contracting party intends, that the audit be utilized.

> Thus, accountants who negligently make an audit of the books of the A Corporation, which they are told is to be used only for the purpose of obtaining a particular line of banking credit, are not subject to liability to a wholesale merchant whom the corporation induces to supply it with goods on credit by showing him the audit and the certification. On the other hand, it is not necessary that the transaction in which the negligent audit is relied on shall be identical in all of its minutest details with the one intended. . . . The question may be one of extent of departure which the maker of the representation understands is to be expected. [T]he question becomes one of whether the departure from the contemplated transaction is so major, and so significant, that it cannot be regarded as essentially the same transaction.[15]

The Restatement rule should be adopted so that the scope of the accountant's liability for a negligent audit is intended to include any contemplated use of the audit and not limited to mere consensual relationship. This rule would be sound because: (1) privity has become an outmoded concept in tort law, and (2) the professional standards of accountants bespeak a broader responsibility to contemplated investors for a negligent audit.[16]

Privity—A Dated Concept in Tort Law

Courts have relied upon the doctrine of privity as a convenient means of limiting the liability of accountants. However, this same doctrine has

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[13] 284 F. Supp. 85 (D. R.I. 1968) at 91, 93.

[14] RESTATEMENT (SECOND) OF TORTS § 552, comment *h* at 23 (Tent. Draft No. 12, 1966).

[15] RESTATEMENT (SECOND) OF TORTS § 552, comment *i* at 26, 27 (Tent. Draft No. 12, 1966).

[16] It should be noted that the Securities Exchange Acts of 1933 and 1934 are patterned after *Ultramares Corporation v. Touche* in some respects and established statutory liability for accountants on the federal level for audits submitted pursuant to these acts. For purposes of this discussion, however, it is important only to note that these Acts did not preempt the field and courts are still free to expand the liability of accountants: "The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity . . ." 15 U.S.C. § 78 bb(a), (1964).

been consistently swept aside in other areas of tort law in order to obtain a duty standard more in keeping with justice and the economic-social needs of society. *Winterbottom v. Wright*[17] established the general rule that a person could not recover from a manufacturer or a seller of a product on the basis of negligence unless there existed a contract between the two parties. It was inevitable that this rule of law, formulated before the industrial revolution, should become subject to exceptions and limitations as the twentieth century was ushered in. The first major exception to the rule of privity was the "inherently dangerous when defective" product.[18] As the exceptions have grown, a number of states, including Wisconsin, have completely rejected the doctrine of privity in a tort action based on negligence.[19] In *Smith v. Atco Co.*[20] the Wisconsin Supreme Court stated:

> We deem that the time has come for this court to flatly declare that in a tort action for negligence against a manufacturer, or supplier, whether or not privity exists is wholly immaterial. The question of liability should be approached from the standpoint of the standard of care to be exercised by the reasonably prudent person in the shoes of the defendant manufacturer or supplier. Such an approach will eliminate any necessity of determing whether a particular product is "inherently dangerous."[21]

The same view was expressed in *Todd Shipyards Corporation v. United States:*[22] "The real answer to the argument, however, is that the asserted rule relied on (privity), though formerly widely followed, has shrivelled up and died in the light of modern reason and authority."[23]

The same forces of change and progress which forced a retreat from *Winterbottom v. Wright*[24] are also forcing a reexamination of the privity requirement established in *Ultramares Corporation v. Touche.*[25] The revolution in economics and its impact on accountants was highlighted by Mr. J. W. Queenan[26] in an address to the Third Congress of Chartered Accountants of South Africa on April 25, 1966:

> The economic system, after having progressed at a relatively slow pace for centuries has been revolutionized by the advancement in technology and by changes in the industrial organizations and government activities. Many enterprises have come to rely on external capital and credit which has separated ownership

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[17] 152 Eng. Rep. 402 (Ex. 1842).
[18] MacPherson v. Buick Motor Co., 217 N.Y. 382, 111 N.E. 1050 (1916).
[19] To date, 19 states have completely rejected the doctrine of privity in negligence actions. *See* Annot., 54 A.L.R. 2d 345 (1957) and A.L.R. 2d LATER CASE SERVICE.
[20] 6 Wis. 2d 371, 94 N.W.2d 697 (1959).
[21] *Id.* at 383, 94 N.W.2d at 704.
[22] 69 F. Supp. 609 (S.D. Me. 1947).
[23] *Id.* at 610.
[24] 152 Eng. Rep. 402 (Ex. 1842).
[25] 255 N.Y. 170, 174 N.E. 441 (1931).
[26] Managing partner, Haskins and Sells.

> from management. These developments have had a vital impact on the economy of the free world and on the progress of our profession. Accounting has become increasingly important for internal administration and control and for external financial reporting. In countries with a highly developed industry . . . the accounting profession has progressed from a small group of practitioners concentrated in a few centers of population and unrecognized publicly, to a well organized profession enjoying world wide influence.[27]

In commenting upon *Ultramares Corporation v. Touche,*[28] the Court in *Texas Tunneling Co. v. City of Chattanooga* stated:

> Without passing upon matters not before this Court, it may be observed in this connection that there have been significant changes in the American society during the 30 years that have elapsed since the decision in the *Ultramares* case. The continued growth and expansion of industry, the growth of population, the urbanization of society, the growing complexity of business relations and the growing specialization of business functions all require more and more reliance in business transactions upon the representations of specialists.[29]

There appears to be little substantive difference between a manufacturer who puts his goods on the market and the accountant who prepares an audit. Just as a retailer turns to the manufacturer for goods which he can distribute to the consumer, so the corporation goes to the accountant for an independent audit that can be distributed to obtain financing. The fact that an auditor doesn't know the specific parties who will be relying upon his audit is as immaterial to a standard of duty as is the case with a manufacturer. The result of a negligently prepared audit upon investors is just as "foreseeable" as damage to the consumer who buys a negligently manufactured product.

However, the accountant, like the manufacturer, should not be held liable for any use made of an audit which was not contemplated in its preparation. In addition, any investor bringing suit against the accountant must prove that he did in fact rely upon the audit. Thus, an investment based on a "tip" or any information other than a personal analysis of the audit would render a negligently prepared audit immaterial. In this respect, the scope of an accountant's potential liability is

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[27] Queenan, *Accountant of Tomorrow,* 33 VITAL SPEECHES, 200 (Jan. 15, 1967).

[28] 25 N.Y. 170, 174 N.E. 441 (1931).

[29] 204 F. Supp. 821 at 833 (E. D. Tenn. 1962), *rev'd,* 329 F. 2d 402 (6th Cir. 1964). This case dealt with the negligence of an engineering firm in omission of geological data from a boring log report which misled the plaintiff subcontractor who was not in privity with the defendant engineer. While the District Court held the defendant firm liable for negligence, the decision was reversed on appeal because there was a disclaimer and warning involved to the contractor and the defendant did not know the plaintiff at the time the report was made. For an analysis of this case and its application to negligent audits, *see* Bradley, *Liability to Third Persons for Negligent Audit,* 1966 THE JOURNAL OF BUSINESS LAW, 190.

greatly reduced, for a large number of investors (stockholders) cannot effectively analyze a balance sheet. Even if an investor can establish that he has sufficient expertise to read a balance sheet, he must still convince a jury that his investment was in fact based upon his reliance on a negligent audit.

Professional Responsibility to the Investor

Courts have limited the liability of accountants to third parties, but the accounting profession itself has recognized that their primary obligation is not to the contracting party but to the investor.[30] Accountants have also proclaimed that investors should "look upon the accountant as an impartial investigator in whom full reliance may be placed for the disclosure of all information relative to accountants which they are rightfully entitled, whether such information be favorable or unfavorable to the interests of the management."[31] However, it has been alleged that some accounting firms are "willing to bend to the will of management for fear that the company will go to the competition in this highly competitive business."[32] This exemplifies the need for the same legal standard of care between accountant and investor as now exists between accountant and corporation.[33] If professional standards are to be insured, the accountant should owe a duty of reasonable care to both investor and corporation.

The needs of the investor (an objective appraisal of the corporation), not that of the corporation, are the motivating factors which prompt an independent audit. Thus, it becomes a highly questionable practice to allow a profession to be employed and gain the benefits of a position of trust, without insisting it assume the responsibilities which accompany that position.

Liability of Accountants to Third Parties for Negligence: An Undue Burden?

If accountants are held liable for negligence to all reasonably foreseeable parties within the scope of intended use of the audit, what will be the effect on the profession? The spectre of undue burden compelled

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[30] *See* May, *The Accountant and the Investor,* VAWTER LECTURES (1932), reprinted in part in 1942 WIS. L. REV. 391.

[31] Andersen, *The Accountant and the Investor,* VAWTER LECTURES (1932), reprinted in part in 1932 WIS. L. REV. 391.

[32] New York Times, Nov. 20, 1966, § 3, at 1, col. 1. An example of the pressure which is brought to bear on some accountants was described by an accountant hired by a construction company which "cailmed a lot of work in progress that I never saw. In my certification of his annual report, I qualified it by saying that I never saw them. When the executive came back from the bank after having been denied a $100,000 loan because of my qualification, he was furious and wanted me to drop it. I refused and he fired me saying 'I'll get a C.P.A. who'll play ball with me!'" Wall Street Journal, Nov. 15, 1966, at 1, col. 1.

[33] The court in *Rusch Factors, Inc. v. Levin,* 284 F. Supp. 85 (D. R.I. 1968) at 91 made passing reference to this factor: "Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession?"

the court in *Ultramares Corporation v. Touche*[34] to limit accountant's liability for negligence:

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.[35]

However, the point overlooked in *Ultramares Corporation v. Touche* is that liability is based on the standard of the professional accountant.[36] Thus an accountant will not be an insurer of the financial success of investors, nor will liability fall for every "thoughtless slip or blunder."[37] The burden of professionalism was underscored by Mr. Walter E. Hanson[38] in a paper delivered to the New York Bar Association, February 3, 1966: "He (the accountant) is expected to, and must have, the skills and competence of his profession, and he willingly accepts the responsibility."[39]

Liability for professional negligence to third parties will not automatically result in injustice and financial ruin being levied upon accountants. Rather, the result will be to insure the use of professional standards. If a corporation limits the investigation of an independent accountant, or if goods or work in progress cannot actually be seen, the accountant can note this in his report. In this manner an accountant can limit the basis upon which an investor can bring suit against him. But more important, such a step would also be in keeping with sound accounting principles and consistent with a sense of professionalism.

It is inevitable that an accountant will at some time be negligent. For this contingency liability insurance is available to accountants.[40]

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34 255 N.Y. 170, 174 N.E. 441 (1931).

35 *Id.* at 179, 174 N.E. at 444.

36 The general standards are: "1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor: 2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor and the auditors: 3. Due professional care is to be exercised in the performance of the examination and the preparation of the report. AUDITING STANDARDS AND PROCEDURES, issued by the Committee on Auditing Procedures of the American Institute of Certified Public Accountants, 666 Fifth Avenue, New York, N.Y.

37 Ultramares Corporation v. Touche, 225 N.Y. 170, 174 N.E. 441, 444 (1931).

38 Member, Council of American Institute of Public Accountants.

39 Hanson, *Responsibilities of Independent Public Accountants,* 22 THE BUSINESS LAWYER, 975 (1967).

40 There appears to be some conflict as to the availability of insurance for accountants. It was reported that in 1965 15 firms were underwriting accountants liability, and by the end of 1966 that number had dropped to six, and the premium costs increased by 30% in 1966. Wall Street Journal, Nov. 15, 1966, at 1, col. 1. However, a more recent publication indicates that a total of nine insurance companies are underwriting accountants liability. One of these companies supplies coverage as a special accommodation, and seven write for a particular class of accountants on a ilmited basis. POLICY FORM AND MANUAL

Basing accountant's liability on the contemplated use of an audit rather than a consensual relationship will increase the cost of liability insurance. However, this added expense will be passed on to the business community in the form of higher fees. The corporation will in turn either pass on the cost to consumers, or the stockholder will receive a smaller dividend. The end result will be greater protection to the public served by the accounting profession.

Conclusion

Rusch Factors v. Levin established a reasonable basis for accountant's liability; the contemplated use of the audit known by the accountant. This case recognized the independent audit as the primary source of reliable information to the investor. The decision is justified in light of the professional standard of the accountant and the fact that a duty standard based on a consensual relationship is no longer applicable to negligence cases. It is submitted that these factors justify an abrogation of the privity requirement established in *Ultramares Corporation v. Touche,* and an expansion of the accountant's liability to third parties for negligence premised on the contemplated use of the audit known to the accountant when preparing his report.

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Federal Taxation—Income in Respect of a Decedent—Discount Notes: In the case of *Levin v. United States,*[1] the First Circuit Court of Appeals considered several questions in the area of federal estate and income taxation. In the *Levin* case, an action was brought by an executrix to recover an alleged overpayment of income tax by the estate. Since the actual facts involved in the controversy were quite complicated, the court adopted a simplified example in order to better illustrate the legal principles involved.

In the hypothetical transaction adopted by the court, the decedent had lent $8,000 in return for a four-year note having a face value of $10,000 and an interest rate of 6%. The $2,000 difference between the amount advanced and the face value of the note was designated "discount income." In reporting his taxable income, the decedent had employed the cash method of accounting. Thus, as he received payments on the face (*i.e.,* excluding the 6% interest) he allocated 80% to principal and 20% to "discount income." For his own records he had used the accrual method of accounting and had recorded the discount in equal installments each year, regardless of whether the entire amount was paid. At the time of the decedent's death (two years after the note had been executed), he had been

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ANALYSIS SERVICE, *Accountant's Professional Liability Policy (§ 273.1),* published by Rough Notes Co. Inc., Indianapolis, Indiana (July 1968).

[1] Levin v. United States, 373 F.2d 434 (1st Cir. 1967).